

WILL  
501.07-05  
INTERNAL REVENUE SERVICE

Department of the Treasury

Person to Contact:

Telephone Number:

Refer Reply to:

Date:

COPY

CERTIFIED MAIL

Dear Sirs:

We have completed our examination of your Form 990 for the period ended . It  
has been determined that your exempt status should be revoked.

The enclosed report of examination states the basis for the revocation. You have agreed with our determination and have signed an agreement to that effect (Form 6018, *Consent or Proposed Adverse Action*). Accordingly, your exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code has been revoked effective .

This is a final adverse determination of your exempt status under section 501(c)(7) of the Internal Revenue Code.

You have filed Forms 1120, *U.S. Corporate Income Tax Return*, for the periods ending .  
are you are required to file Form 1120 for subsequent years with the Internal Revenue Service.

Thank you for your cooperation.

Sincerely yours,



R. C. Johnson  
Director, EO Examinations

Enclosure

**Explanation of Items**

Name of Taxpayer

Year/Period Ended

Issue under Consideration

Does \_\_\_\_\_ qualify to be exempt from Federal income tax under Internal Revenue Code section 501(c)(7)?

Facts

The \_\_\_\_\_ was incorporated in \_\_\_\_\_ and was granted tax exemption under Internal Revenue Code (IRC) 501(c)(7) as a social club in a letter from the Internal Revenue Service dated \_\_\_\_\_.

The \_\_\_\_\_ is an off shoot organization of the \_\_\_\_\_. Its Articles of Incorporation state that the corporation was formed for the purpose of owning, operating, maintaining and managing a building for the purpose of promoting intellectual culture, high moral standards and virtue conducive to the welfare and best interest of the community and particularly the members of the cooperation, by providing a place for social intercourse, reading room, athletic equipment, or such other facilities as may tend to encourage their physical, mental and cultural development.

Its Articles of Incorporation also state that the membership of the corporation shall be composed of the members in good standing of \_\_\_\_\_ and none other.

The amounts reported on the organization's timely filed Forms 990-T as taxable income (unrelated business income) is equal to 100% of the income reported on the organization's timely filed Form 990. In other words, all of the income received by the organization is considered to be unrelated business income per the filed returns.

Law and Argument

Internal Revenue Code 501(c)(7) describes as exempt, as provided under IRC 501(a), "clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder." The tax treatment of social clubs is designed to allow individuals to join together to provide themselves with recreational or social facilities on a mutual basis without tax consequences. It operates properly only when the club's sources of income are limited to its membership, so the member is in substantially the same position as if he had spent his after-tax income on pleasure or recreation without the intervening organization.

Section 501(c)(7) was amended in 1976 to provide that social clubs could receive some income from sources outside the membership without losing their exempt status. The legislative history indicates that Congress intended to liberalize prior IRS limitations on the portion of income a social club may receive from nonmember use of its facilities and investment income. However, the Senate committee report states the intent is not "that these organizations should be permitted to receive, within permitted allowances, income from the active conduct of businesses not traditionally carried on by these organizations."

**Explanation of Items**

Name of Taxpayer

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The Committee Reports for Public Law 94-568 (Senate Report No. 94-1318 2d Session, 1976-2 C.B. 597) state that it is intended that social clubs should be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their memberships without losing their exempt status.

- (a) Within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter do not represent more than 15 percent of total receipts.
- (b) Thus, a social club may receive investment income up to the full 35 percent amount of its gross receipts, where a social club receives no income from non-members' use of club facilities.
- (c) In addition, the Committee Reports state that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facilities, that income is not to be included in the 35 percent formula.

Internal Revenue Code (IRC) section 512(a)(1) states that "unrelated business taxable income" is the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business.

IRC section 512(a)(3)(A) states that in the case of an organization described in IRC section 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed which are directly connect with the production of the gross income (excluding exempt function income).

Internal Revenue Code 512(a)(3)(B) exempts social clubs only to the extent of their "exempt function income," which is defined as the gross income from dues, fees, charges, and other income generated by club members pursuant to the organizations' nonprofitable purposes. Income received from the general public or from investments is treated as unrelated business taxable income and is taxed at general corporate rates.

Section 513(a) of the Internal Revenue Code states that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business, the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Examples of taxable income include investment income or income generated from nonmembers through traditional activities: i.e., those activities that if conducted with members further a social purpose.

**Explanation of Items**

Name of Taxpayer

Year/Period Ended

Revenue Procedure 71-17 details Public Law 94-568 and sets forth the guidelines for determining the effect gross receipts derived from use of social club's facilities by the general public has on the club's exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code. These guidelines will be used in connection with the examination of annual returns on Forms 990 and 990-T filed by social clubs. This revenue procedure also describes the records required when nonmembers use a club's facilities and the circumstances under which a host-guest relationship will be assumed, which are relevant both for purposes of determining adherence to the exemption requirements and for computing exempt function income under section 512(a)(3) of the Code.

Section 4 of Revenue Procedure 71-17 provides the recordkeeping requirements. Section 4.03 of Revenue Procedure 71-17 states that the occasions involving use by non-members the club must maintain books and records of each such use and the amount derived therefrom. This requirement applies even though the member pays initially for such use. In each instance, the record must contain the following information:

- 1) the date;
- 2) the total number in the party;
- 3) the number of non-members in the party;
- 4) the total charges;
- 5) the charges attributable to non-members;
- 6) the charges paid by nonmembers; and
- 7) where a member pays all or part of the charges attributable to non-members, a statement signed by the member indicating whether the has been or will be reimbursed for such non-member use, and if so, the amount of the reimbursement.
- 8) Attached is a sample worksheet that includes these items

Section 4.04 of Revenue Procedure 71-17 provides that if a club fails to maintain or make available the records required by that revenue procedure, the percentage guidelines may not be used in the determination of whether the club has a non-exempt purpose.

Revenue Ruling 60-324 holds that a club no longer qualifies for exemption from Federal income tax under section 501(c)(7) of the Code if it makes its club facilities available to the general public on a regular, recurring, basis since it may then no longer be considered to be organized and operated exclusively for its exempt purpose.

Revenue Ruling 69-220 states that a social club that receives a substantial portion of its income from the rental of property and uses such income to defray operating expenses and to improve and expand its facilities is not exempt under section 501(c)(7) of the Code.

Revenue Ruling 69-219 states that a social club that regularly holds its golf course open to the general public, charging established green fees that are used for maintenance and improvement of club facilities, is not exempt under section 501(c)(7) of the Code.

**Explanation of Items**

Name of Taxpayer

Year/Period Ended

In Pittsburgh Press Club v. United States, the social's club exemption was lost through excessive general public gross receipts.

**Government's Position**

A social club's exemption does not operate properly when it receives income from sources outside its membership, because the members will receive a benefit not contemplated by the statute in that untaxed dollars are used by the organization to provide pleasure or recreation to its membership. To prevent club members from receiving benefits not contemplated by IRC 501(c)(7), the receipt of nonmember income and investment income is permitted up to certain limits without jeopardizing exemption, but the net income from these sources is made taxable by the clubs by IRC 512(a)(3).

A nonmember is considered to be a person from the general public who is provided recreational and social services by the organization and pays for these services. A paying nonmember is a purchaser of the goods or services provided by the organization, and is a direct recipient of those goods or services from the organization. Such a nonmember is not considered to be entertained by a member even when accompanied by a member but is instead considered to be a principal in a business transaction with the organization. The host-guest relationship is missing when the nonmember pays.

A social club may derive up to 15% of its gross receipts from nonmember use of club facilities and/or services without jeopardizing its exempt status. It is important to distinguish nonmember use from member use of the facilities and services. An issue that arises is whether an individual or a group is a true guest of a member. This is important because income from bona-fide guests is treated as member income. The amendment to IRC 501(c)(7) by P.L. 94-568 does not affect what constitutes public use of club facilities and prior precedent on this question should still be followed.

Where goods or services are furnished to nonmembers who provide payment for such goods or services, their furnishing is outside the scope of section 1.501(c)(7)-1(b) of the regulations. Generally, if an organization has not kept adequate books and records concerning its financial transactions with nonmembers and more than 15 percent of its gross receipts are derived from sales transactions (e.g. restaurant and bar sales) to non-members, the presumption will be that the organization's exempt status should be revoked because it is not primarily engaged in section 501(c)(7) activities.

Although making an organization's recreational facilities available to members to entertain their guests may be considered part of providing social and recreational activities to members and thus to further that exempt purpose, merely being accompanied by a member does not mean that an individual is being entertained by a member. When the guest pays the exempt organization for its bar and restaurant services, he or she is not being entertained by a member. Instead, in that situation, the IRC 501(c)(7) organization is providing social and recreational activities directly to a nonmember rather than as a service to a member. Consequently, the income received by an IRC 501(c)(7) organization from sales to nonmembers who pay their own way is subject to unrelated business income tax if the sales activity is regularly carried on and none of the other exceptions under IRC 512 or 513 apply.

**Explanation of Items**

Name of Taxpayer

Year/Period Ended

All income of an organization that is otherwise organized and operated within the meaning of IRC 501(c)(7) should be considered as income from unrelated business if no records are maintained to determine if such income is related to exempt activities/purposes. (note: IRC 512(b) provides modifications to the definition of unrelated business taxable income. Therefore, income from sources not related to exempt activities/purposes might not be considered as unrelated business taxable income. For example, hall rental income would not be unrelated business taxable income (UBTI) unless services are rendered or the property is "debt-financed".)

Income that an organization claims is related or partially related to exempt activities/purposes of the organization must be substantiated by the maintenance of records by the organization in sufficient detail to determine whether the income is related to the exempt activities/purposes of the organization and whether the income is derived from members or nonmembers.

Organization's Position

Unknown at this time

Conclusion

Based upon the information noted above, it is proposed the exempt status of the organization be revoked as of the fiscal year . Forms 1120, *U.S. Corporation Income Tax Return* should be obtained for the fiscal years, to

Amended Forms 990-T cannot be filed for these years to differentiate member and nonmember income because records on non-member usage of the facilities have not been kept according to Revenue Procedure 71-17.

The organization may re-apply for tax exemption under IRC 501(c)(7) but should use improved recordkeeping procedures that will comply with Revenue Procedure 71-17 (noted above) and which could also include such factors as:

- All members should provide a membership number to purchase restaurant and bar services and the membership number entered on the receipt. If the membership number is not on the receipt, the presumption is that services are to nonmembers.
- Carbons of the receipts will be retained by the organization. To distinguish member and nonmember receipts, the copies of member receipts should be a different color from the copies of nonmember receipts.
- When the member pays for the services rendered to a guest or guest, the income will be considered member income. A member will be issued a member receipt indicating the member paid for the services provided to the guest.

**Explanation of Items**

Name of Taxpayer

Year/Period Ended

- If the member brings nonmembers but does not pay for them, they cannot be considered guests, and these nonmembers should receive nonmember receipts for services provided to them. The member will receive a member receipt for services provided to the member.
- Where a member pays all or part of the charges attributable to nonmembers, a statement signed by the member indicating whether he has been or will be reimbursed for such nonmember use and, if so, the amount of the reimbursement.
- Where a nonmember makes payment to the organization or reimburses a member and a claim is made that the amount was paid gratuitously for the benefit of a member, a statement should be signed by a member indicating the donor's name and relationship to the member, and containing information to substantiate the gratuitous nature of the payment or reimbursement.
- For occasions in which the organization is dealing with nonmembers and wishes to contest the presumption that the income is subject to the unrelated business income tax, the organization's books and records must contain the following information:
  - (a) the date
  - (b) purpose of function
  - (c) the total number in the party
  - (d) whether a member sponsors the function and, if so, the name of the sponsor
  - (e) the number of members in the party
  - (f) the number of nonmembers in the party
  - (g) the total charges
  - (h) the charges paid by a member
  - (i) the charges paid by nonmembers